The Disappearing Size Effect: Evidence From Dual Class Shares

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Abstract

Two portfolios are formed using dual class shares, one with small and the other with large market value. Even though both portfolios contain the same firms and therefore similar risk, a small firm effect comparable in magnitude to previous studies is found. Then only dual class shares with equal dividend and liquidation treatment are selected, and the trading-related risk factors are controlled for using returns based solely on the mean of the closing bid-ask spread. No significant difference in returns between the portfolios is found. This finding suggests that if previous size effect studies were able to adjust their market value portfolios for total risk (both market-wide and trading-related risk factors), they may not have found differences in risk-adjusted returns between small market value and large market value firms.

Introduction

Practitioners, academics, and individual investors continually search for methods to increase portfolio returns without an offsetting increase in risk. One of the methods currently under scrutiny is the so-called small firm effect (Banz, 1981), which suggests that returns on small market value firms exceed returns on large market value firms, even after adjusting for differences in market risk. The small firm effect has been discussed many years. It has been related to P/E ratios (Reinganum, 1983), month-of-the-year returns (Keim, 1983; Reinganum, 1983), day-of-the-week returns (Harris, 1986; Keim, 1984), trading volume (James and Edmister, 1983), prices (Kross, 1985), information content of financial statements (Zeghal, 1984), and broker neglect (Arbel and Strebel, 1982; Barry and Brown, 1984). It has been examined internationally (Chan, Hamao, and Lakonishok, 1991; Gultekin and Gultekin, 1983; Kato and Schallheim, 1985), using different risk adjustments (Friend and Lang, 1983; Chan and Chen, 1988), different portfolio formation methods (Cook and Rozeff, 1984), and dif-

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ferent time periods. Yet the question remains: do small market value firms provide greater risk-adjusted returns than large market value firms?

A major obstacle in previous studies is the method of risk adjustment. There is no consensus that security pricing models (such as CAPM or APT) correctly adjust for total risk across different market value portfolios. For example, Friend and Lang (1983) suggest that the Standard & Poor's quality ranking for stocks is a better measure of market-wide risk than are estimates of beta from historical data. Amihud and Mendelson (1986) suggest risk measurements should include a measure of liquidity costs in addition to market-related risk. CAPM and APT do not adjust for differences in trading-related risk such as differences in bisk-ask spreads[1] because they are derived in a world where these risks are assumed to be zero. An ideal study would exist if small and large market value portfolios could be formed where it were known that both portfolios have the same market-wide risk factors such as differences in sensitivity to unanticipated changes in inflation (a possible factor in APT suggested by Chen, Roll, and Ross, 1986) or sensitivity to a major market index, thereby eliminating the need for risk proxies based on security pricing models. Then if portfolio returns differed even after adjustments for differences in trading-related risk, it could be concluded that the size effect is not the result of improper risk adjustment.

Such a study is highly improbably if different firms are placed in each portfolio; however, dual class shares provide a unique way of placing identical firms in small and large market value portfolios. Numerous studies, including Lease, McConnell, and Mikkelson (1983), Megginson (1990), Levy (1983), and Jog and Riding (1986), have shown that the superior voting (SV) class of dual class shares in the U.S., Britain, Israel, and Canada tends to have smaller market value than the restricted voting (RV) class. Therefore, two portfolios can be formed, each containing the same firms but with different average market value.[2]

This study is conducted in the following manner. First all firms in the sample are examined for evidence of the size effect. The results are consistent with previous size effect studies and show the expected inverse relationship between

[1]Research such as Demsetz (1968) and Stoll (1978, 1989) have shown the determinants of the bid-ask spread include trading-related risk factors such as trading activity and price volatility.

[2]The majority of securities in previous studies are associated with individual firms. Discussions with previous small firm effect researchers confirmed that each dual class security was treated as an individual firm. The securities in this study represent individual firms, but each firm has more than one traded security. Because each security is traded individually, it can respond to different expected cash flows individually and, therefore, can exhibit market value, bid-ask spread, and other effects individually. The loss of not comparing individual firms rather than individual securities is more than overcome by the benefit of having the same firms in both small and large market value portfolios which results in the ability to match market-wide risk factors without the use of risk proxies.

market value and returns.[3] Then the dual class shares are examined by forming two portfolios, each containing the same firms, but one with small and the other with large market value. Although the significance levels decrease substantially, magnitudes similar to previous size effects still are found. When only dual class shares having equal dividend and liquidation treatment are examined and when returns are calculated using the mean of the closing bid and ask, however, the size effect disappears; average returns on the two portfolios are virtually identical. This finding implies that the size effect may result from unequal comparison of total risk, where total risk includes both market-wide and trading-related risk factors.

Data

The dual class shares listed on the Toronto Stock Exchange (TSE) from December 1979 to December 1987 are examined. The Canadian markets and securities regulations closely follow those of the U.S., but the TSE has not restricted firms from issuing dual class shares as has the NYSE. Also, of the more than 100 firms listing dual class shares on the TSE over the sample period, 36 have equal dividend and liquidation treatment, allowing more precise matching between classes.[4] The TSE made available closing daily bid and ask quotations for dual class shares over the sample period, allowing examination of possible bid-ask spread differences between share classes.[5]

The returns data are from the Toronto Stock Exchange/University of Western Ontario (TSE/UWO) daily database and include daily returns adjusted for dividends and stock splits for all stocks listed on the TSE from December 1979 to December 1987. The total number of stocks ranges from 717 in 1980 to 1,128 in 1987. The number of dual class firms for which all data are available (transaction returns and closing bid and ask prices) ranges from 24 in 1980 to 78 in 1987.

The data of the current study exhibit characteristics similar to the data of previous studies. An appendix lists the issued capital and trading volume for the

[3]Several previous studies, including Keim (1986), show how the small firm effect occurs primarily in January. A recent study by Jones, Lee, and Apenbrink (1991) again raises the possible relationship between the small firm effect and tax loss selling.

[4]Coattail provisions, where takeover bidders are required to provide equal treatment to all share classes, also may be important The majority of the sample have explicit coattail provisions. Also, firms trading on the TSE tend to have implicit coattail provisions. For example, the attempted takeover of the Canadian Tire Corporation, which began in October 1986, was blocked by the Ontario Securities Commission (the governing body of the TSE) because it failed to offer equal treatment to both voting and nonvoting shareholders.

[5]The bid-ask data were provided by the TSE and are not a part of the TSE/UWO database. The authors with to thank the TSE, Jim Hatch, and Robert White for making these data available.

last full year of data for the 36 firms with equal dividend and liquidation treatment. In 26 of the 36 cases the average issued capital and trading volume of RV shares exceeds that of SV shares, which is consistent with DeAngelo and DeAngelo (1985). It also is found, consistent with Lakonishok and Smidt (1984), that trading volume is related positively to market value. Price differences across classes were tested—SV minus RV share price is significantly positive. This finding is consistent with previous dual class share studies, including Lease, McConnell, and Mikkelson (1983) and Jog and Riding (1986).

The Size Effect

All TSE Securities

The size effect first is examined in a manner consistent with previous studies. Market value quintiles for all TSE securities using the market value of equity based on the last trading day in December of the previous year were formed. For example, December 1979 market values are used to form market value quintiles in 1980. Securities remain in a particular quintile for the entire year. Dual class shares are handled as in previous small firm studies where securities (not firms) are sorted by market value, resulting in dual class shares acting as individual firms. (The following section demonstrates that dual class shares acting as individual firms can and do produce the small firm effect.) A dummy variable regression similar to Keim and Stambaugh (1986) and Jaffe, Keim, and Westerfield (1989) then is used to estimate mean portfolio returns and test hypotheses:

$$(1)\ R_{pt} = a_{p1}D_t^{JAN} + a_{p2}(1 - D_t^{JAN}) + e_{pt},\ p = 1, \ldots, 5\ t = 1, \ldots, T$$

where:

R_{pt} = Daily return on portfolio p on day t;
D_t^{JAN} = Dummy variable that equals one if day t is in January and 0 otherwise; and
$(1 - D_t^{JAN})$ = Dummy variable representing non-January months.

The estimates of equation (1) are shown in Table 1 and contain patterns similar to Keim (1987). The median market values of the TSE stocks are smaller than those of the Keim study using NYSE and AMEX securities. The average median value for Keim's smallest portfolio is $5.0 million, compared to C$2.0 million in the current study. Keim's largest portfolio has an average median value of $1,394.8 million, versus C$436.6 million in the present case. The size

effect for all days of 0.217 percent (i.e., the difference in daily mean returns between the smallest and largest size portfolio), which is larger than found in previous studies, may be the result of the smaller average portfolio market values. January average daily returns of 0.644 percent for portfolio 1 (the smallest market value quintile) are almost three times larger than portfolio 2, the next highest January return.

All Dual Class Shares

Next only dual class share are examined for evidence of the size effect. First, the market value quintiles of each share class, for each year, of only those firms with dual class shares are determined. When the two classes are in different quintiles, the class with the larger market value is included in the large portfolio, and the class with the smaller market value is included in the small portfolio. If both classes of stock fall in the same market value quintile, they are discarded from the sample for that particular year. The average median values of the small portfolio and the large portfolio are C$19.4 million and C$48.9 million which are comparable with the largest market values contained in portfolios 2 and 3, respectively, for all TSE securities.

The resulting small and large portfolio average daily returns are shown in Table 2, which also shows the returns for TSE portfolios 2 and 3. Returns for all days of 0.104 percent and 0.061 percent for portfolios 2 and 3 are similar to 0.100 percent and 0.068 percent for the small and large dual class portfolios. The average daily returns difference between the two dual class portfolios of 0.032 percent is approximately 8.0 percent on an annual basis, an order of magnitude similar to earlier studies comparing smallest and largest deciles (or quintiles) such as Keim (1986) and Berges, McConnell, and Schlarbaum (1984). The results are important, considering the much smaller average market value difference in the two current portfolios. The difference in median values between the largest and smallest portfolio is about $C29.5 million versus Keim's $1.0 billion and Berges, McConnell, and Schlarbaum's C$360.1 million. Further, the dual class size effect results from what are effectively adjacent portfolios when compared to the quintiles for all TSE securities and contain the same firms. The non-January average daily returns difference for the dual class shares of 0.040 also is similar to the returns difference of 0.039 between portfolios 2 and 3, but the significance level drops from 0.004 to 0.067.

Contrary to TSE portfolios 2 and 3, January returns on the dual class large portfolio are greater than the small portfolio returns, although the difference (-0.064) is not significant (p-value = 0.458). Although these results may appear paradoxical at first, they are consistent with the well-known tax-loss selling hypothesis. Turn-of-the-year differences related to tax-loss selling are not

expected; similar selling pressures (and rebounds) are expected on both portfolios because each contains the same firms.

Dual Class Shares With Equal Dividend and Liquidation Treatment

Even though the two dual class portfolios contain the same securities, many of the firms have different dividend and liquidation treatment across the two share classes. These differences may confound the results; therefore, the previous study is repeated using only those firms with equal dividend and liquidation treatment. The small and large portfolios are formed in the same manner, and each portfolio contains the same firms. The average median value of the two portfolios increases slightly to C$21.7 million and C$55.1 million, respectively.

Table 3 shows the average return difference between the small and large portfolio increases from 0.032 percent to 0.046 percent, but the significance level declines to 0.270. The returns difference in January increases from -0.064 percent to -0.139 percent, but remains insignificant ($p = 0.341$). The non-January returns difference increases from 0.040 percent to 0.063 percent, but the significance level declines from 0.067 to 0.150. These findings emphasize the importance of exact matching of portfolios for meaningful interpretation of the relationship between market value and return.

Bid-Ask Differences

Blume and Stambaugh (1983) have shown that part of the size effect may be due to wider spreads for smaller market value securities. To determine what part of the current findings may be the result of spread differences, a daily returns file was created based on the closing bid-ask spread data supplied by TSE. Returns are calculated based on the mean of the closing bid-ask spread and are adjusted for dividends and splits. The previous dual class analysis then is replicated using the spread-adjusted returns. The results presented in Table 4 show the virtual disappearance of all market value differences. The overall size effect declines from 0.046 percent to 0.002 percent only for those dual class shares with equal dividend and liquidation treatment. The January difference remains stable, -0.139 percent using transaction returns versus -0.138 percent with bid-ask-adjusted returns. The non-January difference, which was significant with transaction returns at the 0.150 level, is now not significant (p-value = 0.778).

Conclusions

Market value portfolios are formed using dual class shares. Because each portfolio contains the same securities but has different average market value, the

current research is able to control for risk across different market value portfolios in a manner not possible in previous studies. Size and January effects similar in magnitude to previous studies are found. The two portfolios are refined by selecting only those dual class shares with equal dividend and liquidation treatment. Bid-ask spread biases are controlled using returns based solely on the mean of the bid-ask spread. This method of matching total risk differences between two portfolios of different market value results in no significant differences in returns, on average, or in January. This finding suggests the size effect may be the result of incomplete risk adjustment. The results imply selection of small market value securities for a particular portfolio should be done on the basis of diversification, not on the expectation of achieving excess risk-adjusted returns. They also suggest that investors investing in mutual funds containing solely small market value securities should not expect excess risk-adjusted returns, particularly if their total portfolio is not fully diversified.

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Table 1
Average Daily Percentage Returns for Five Market Value Portfolios for Stocks Traded on the TSE Between 1980 and 1987 Using Returns Calculated With Transaction Prices
(p-value[a])

Market Value Portfolio	Market Value (C$ millions)[b]	All Days	January	Non-January
1	2.44	0.273	0.644	0.239
		(*)	(*)	(*)
2	9.59	0.104	0.238	0.092
		(*)	(0.002)	(*)
3	26.18	0.061	0.155	0.053
		(0.004)	(0.036)	(0.018)
4	83.40	0.063	0.169	0.053
		(0.002)	(0.014)	(0.011)
5	436.59	0.056	0.148	0.048
		(0.005)	(0.033)	(0.022)
1 Minus 5		0.217	0.497	0.191
		(*)	(*)	(*)
F			13.12	21.38
			(*)	(*)
Number of observations		2,017	169	1,848

[a]The p-value represents the probability of obtaining a sample mean value different from zero when the true value is equal to zero. p-values of (*) are less than 0.001

[b]The market value for a portfolio is measured by the average across all sample years of the median market values of that size portfolio

[c]The F-statistic tests the equality of mean returns across the five market value portfolios

Table 2
Small Market Value Versus Large Market Value Portfolio Percentage Average Daily Returns Comparison for Dual Class Shares Traded on the TSE Between 1980 and 1987 Using Returns Calculated With Transaction Prices
(p-value[a])

Market Value Portfolio	All Days	January	Non-January
Dual Class Shares	0.100	0.126	0.097
Small Portfolio	(*)	(0.105)	(*)
Dual Class Shares	0.068	0.190	0.057
Large Portfolio	(0.001)	(0.009)	(0.009)
All TSE Shares	0.104	0.238	0.092
Portfolio 2	(*)	(0.002)	(*)
All TSE Shares	0.061	0.155	0.053
Portfolio 3	(0.004)	(0.036)	(0.018)
Dual Class Shares	0.032	-0.064	0.040
Small Minus Large	(0.134)	(0.380)	(0.067)
All TSE Shares	0.043	0.083	0.039
2 Minus 3	(0.001)	(0.068)	(0.004)
Number of Observations	2,017	169	1,848

[a]The p-value represents the probability of obtaining a sample mean value different from zero when the true value is equal to zero. p-values of (*) are less than 0.001

Table 3
Small Market Value Versus Large Market Value Portfolio
Percentage Average Daily Returns Comparison for Dual Class Shares
With Equal Dividend and Liquidation Treatment
Traded on the TSE Between 1980 and 1987
Using Returns Calculated With Transaction Prices
(p-value[a])

Market Value Portfolio	All Days	January	Non-January
Dual Class Shares	0.115	0.128	0.114
Small Portfolio	(0.006)	(0.372)	(0.009)
Dual Class Shares	0.068	0.267	0.050
Large Portfolio	(0.044)	(0.023)	(0.156)
All TSE Shares	0.104	0.238	0.092
Portfolio 2	(*)	(0.002)	(*)
All TSE Shares	0.061	0.155	0.053
Portfolio 3	(0.004)	(0.036)	(0.018)
Dual Class Shares	0.046	-0.139	0.063
Small Minus Large	(0.270)	(0.341)	(0.150)
All TSE Shares	0.043	0.083	0.039
2 Minus 3	(0.001)	(0.068)	(0.004)
Number of Observations	2,017	169	1,848

[a]The p-value represents the probability of obtaining a sample mean value different from zero when the true value is equal to zero. p-values of (*) are less than 0.001

Table 4
Small Market Value Versus Large Market Value Portfolio
Percentage Average Daily Returns Comparison for Dual Class Shares
With Equal Dividend and Liquidation Treatment
Traded on the TSE Between 1980 and 1987
Using Returns Calculated With the Mean of the Closing Bid and Ask Prices
(p-value[a])

Market Value Portfolio	All Days	January	Non-January
Dual Class Shares	0.045	0.073	0.043
Small Portfolio	(0.208)	(0.557)	(0.255)
Dual Class Shares	0.047	0.211	0.033
Large Portfolio	(0.134)	(0.054)	(0.325)
Small Minus Large	-0.002	-0.138	0.010
	(0.949)	(0.250)	(0.778)
Number of Observations	2,013	169	1,844

[a]The p-value represents the probability of obtaining a sample mean value different from zero when the true value is equal to zero

Appendix
Dual Class Shares Listed on the TSE Between 1980 and 1987 With Identical Dividend Distribution and Liquidation Treatment

Company	Superior Class (SV)			Restricted Class (RV)		
	Ticker	Issued Capital[1]	Volume[2]	Ticker	Issued Capital[1]	Volume[2]
Arbor Capital	ABO.A	2,609	2,695	ABO.B	5,247	8,300
Atco	ACO.Y	4,221	5,624	ACO.X	26,037	118,753
Argyll Energy	AYE.B	1,178	377	AYE.A	9,898	29,257
Cara Operations	CAO	18,291	38,519	CAO.A	18,499	38,488
Corby Distilleries	CDL.A	6,021	5,594	CDL.B	855	1,399
Central Capital	CEH	26,424	72,749	CEH.A	43,860	215,940
Conwest Exploration	CEX.A	2,032	3,890	CEX.B	9,324	66,124
Canadian Manoir	CMQ	3,492	9,694	CMQ.A	1,600	9,655
Cableshare	CSH.B	3,329	5,724	CSH.A	10,137	36,037
Canadian Utilities	CU.X	24,486	62,542	CU	29,731	81,769
Denison Mines	DEN.A	20,414	38,798	DEN.B	30,429	95,997
Dickenson Mines	DML.B	5,362	11,586	DML.A	9,848	71,593
Doman Industries	DOM.A	6,713	40,006	DOM.B	10,620	96,035
Dalmys Canada	DYC	2,062	380	DYC.C	2,118	1,703
Fleet Aerospace	FLT	5,353	25,530	FLT.A	4,054	24,283
Finning Tractor	FTT	7,919	7,489	FTT.B	7,966	8,425[3]
Guardian Capital	GCG	1,135	1,491	GCG.A	4,619	17,961
GSW	GSW.A	1,177	323	GSW.B	2,495	568
Hammerson Prop.	HPD	35,258	315	HPD.A	126,619	21
Irwin Toy	IWT	2,512	3,296	IWT.A	2,561	8,410
L.K. Resources	LKR.A	2,471	1,916	LKR.B	2,543	1,499[3]
Magna International	MG.B	1,362	510	MG.A	26,524	197,779
Marshall Steel	MS.B	4,311	1,813	MS.A	4,378	2,477
Mirton International	MIN	14,374	15,781	MTN.A	2,842	12,989
Montreal Trustco	NCC.B	10,658	7,618	MTU.B	621	1[4]
Nfld. Capital	NCN	1,270	744	NCC.A	3,655	24,746
Norcen Energy Res.	NPI.B	27,324	157,319	NCN.A	30,019	125,217
Normick Perron	OIL.A	6,647	623	NPI.A	11,816	5,384
Ocelot Industries	SRC.C	3,722	676	OIL.B	11,493	32,753
Scott's Hospitality	SSI.A	23,016	12,778	SRC	36,184	76,489
Slater Industries	SSI.A	2,500	4,439	SSI.B	5,222	21,668
Tombill Mines	TBL.A	2,165	789	TBL.B	3,176	1,395
Turbo Resources	TBR	144,470	393,597	TBR.A	17,486	12
Teck	TEK.A	2,341	6,824	TEK.B	31,078	167,265
Traders Group	TG.B	387	84	TG.A	4,129	20,343
Versatile	VCC.B	12,826	38,136	VCC.A	14,944	59,228[5]

[1]Issued capital in $000s
[2]Trading volume in 100s, based on TSE trading during last full year of available data (1987 unless other wise noted)
[3]Based on 1985 data
[4]Based on 1984 data
[5]Based on 1986 data